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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 001405

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SUBJECT: INTERNATIONAL COMMUNITY CONCERNED ABOUT POSSIBLE  
ECONOMIC "TRAIN WRECK" IN AZERBAIJAN

REF: (A) BAKU 1274 (B) BAKU 1176

Classified By: AMBASSADOR ANNE E. DERSE, PER REASONS 1.4 (B,D)

11. (C) SUMMARY. On September 14 Ambassador Derse hosted the Friends of Azerbaijan Revenue Management Group, a group consisting of representatives from the diplomatic community and international financial institutions. The group discussed the current macroeconomic environment, the challenges facing the country and the Government of Azerbaijan and the urgent need for an unified message from the international community that participants would use with government interlocutors, now under development. According to the group, the economy appears to be a "train wreck" waiting to happen due to the GOAJ's inability or lack of capacity to reform key parts of the economy. Azerbaijan's economy is becoming overly reliant upon its energy resources and the non-oil sector is suffering. The agricultural sector is stagnating at zero percent growth and the government has not found a sound policy balance between maintaining macroeconomic stability and development, including meeting infrastructure and social needs (health, education). Concerns about the 2008 elections and the need to "deliver results" appears to be driving GOAJ spending decisions, putting pressure on macroeconomic stability -- "They are driving their economy off a cliff," the IMF representative said to general agreement.

12. (C) SUMMARY CONTINUED: In a separate meeting on September 6, the IMF's lead staff economist for Azerbaijan said that GDP growth for the first six months of 2006 was 35 to 40 percent faster compared to the same period in 2005. According to official statistics, inflation was 10.2 percent to date for the year. The National Bank continues its policy of currency appreciation and the Azerbaijani manat has already appreciated four percent against the U.S. dollar. While the 2007 budget has not been finalized, the Minister of Finance told the IMF that government expenditures will increase 40 percent compared to the 2006 budget. The concerns expressed by the international community underscore the need for a sustained, senior-level macroeconomic policy discussion with the GOAJ. END SUMMARY.

13. (C) On September 14, Ambassador Derse hosted the Friends of Azerbaijan Revenue Management Group (RMG), consisting of representatives from the diplomatic community and international financial institutions. The discussion focused on the current macroeconomic environment, how much time the Government of Azerbaijan (GOJ) has to reform its economy, before the impact of exploding oil revenue and GOAJ spending

hits, and broader economic reform in managing oil revenues. In addition, participants reviewed the need to develop the non-oil sector and the role of the international donor community in working with the GOAJ to strengthen its oil revenue management. At the end of the meeting, the participants agreed to develop a concerted strategy and core message that could be presented to GOAJ officials at every opportunity. The RMG will meet again in October at the World Bank in order to finalize the core message points and brain-storm on possible next steps to engage the GOAJ as a group.

#### RMG DISCUSSION AND CONCERNS

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14. (C) RMG meeting participants noted that the government's fiscal policy appears to be out of control and that the government's anti-inflationary strategy was unclear. The IMF representative questioned whether the government would allow the Azerbaijani manat to appreciate or allow inflation to edge higher. With a view to the 2008 presidential elections, there is pressure to spend more to deliver results on the social and infrastructure needs. This broader macroeconomic issue appears to be a current topic of debate among the National Bank, Ministry of Finance and Ministry of Economic Development. According to the group, the economy appears to be a "train wreck" waiting to happen due to the GOAJ's inability or lack of capacity to reform key parts of the economy, and its apparent preference to endure higher inflation to allow increased spending.

15. (C) The UN representative stated that efforts to develop the country's "human capital" are critical, especially

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through strengthening education. In addition, the non-oil sector is suffering and for the first six months of 2006 the agricultural sector grew zero percent. In addition, overall farm and agricultural activities appear to be decreasing as more agricultural workers leave rural areas for higher paying jobs in Baku. Overall, the group agreed that the economy is not diversifying and is actually becoming more and more reliant on the energy sector. One of the key problems affecting the economy and its diversification is the role of state monopolies in stifling small and medium enterprises and domestic economic activity. The banking/financial sector is anemic, provides only poor intermediation and its reform is critical. Financing is scarce, high-cost, and short term which is also strangling business development. Several group participants opined that a robust banking sector is critical for intermediation, SME growth and the government's macroeconomic management.

16. (C) As the GOAJ increases public investment and infrastructure projects, the UN rep noted, it must balance macroeconomic stability. The Ambassador stated that Azerbaijan's eventual WTO membership will improve the investment climate and advance legal reforms which will increase overall transparency. All participants agreed, underscoring that endemic corruption is harming the economy. The discussion turned to the window of opportunity for enacting necessary economic reforms before the impact of exploding oil revenue hits. Some participants stated that the window would close in two or three years while others felt that Azerbaijan had as many as 15 years. Several participants noted that the 2008 Presidential elections are already influencing current economic decisions in both positive and negative ways. The Asian Development Bank representative stated that the GOAJ understands necessary reforms but is taking no action - a disturbing possibility.

17. (C) The IMF representative warned that in two to three years Azerbaijan's economy could become totally reliant upon its oil and gas sector if there is no change. The World Bank representative stated that absent reform, Azerbaijan could experience an "Argentine Curse" (hyperinflation) and/or

"Nigerian Curse" (violent conflict for energy resources). In addition, he noted that "Dutch Disease" in Azerbaijan is a misnomer since the non-oil and trade sectors are small and may not alert economic observers to potential difficulties and problems.

#### CURRENT MACROECONOMIC ENVIRONMENT

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¶8. (C) IMF resident representative Basil Zavoico briefed on the recently concluded staff consultations with the Government of Azerbaijan that primarily focused on the 2007 budget process. Zavoico said that the amount of GOAJ spending in 2006 had created a 30 percent non-oil sector fiscal deficit. Zavoico said that the GOAJ appears to have accepted double-digit inflation as an acceptable consequence of rapid growth and modernization, noting that 15 percent seemed to be the threshold for GOAJ economic decision makers. Zavoico told the group that the non-oil sector totaled USD 10 billion, of which more than 50 percent represented government spending. For 2007, the IMF estimates that annual inflation would range between 15 and 20 percent.

¶9. (C) Zavoico briefed the group on the supply side, noting that imports into Azerbaijan had actually dropped during the first six months of 2006. He indicated that the economic system is not flexible since large monopolies control large sectors and inhibit business development. As an example, Zavoico relayed to the group that delivery of apples from Guba to Baku had been restricted in favor of apples imported from Iran and controlled by a large monopoly. Zavoico said that for Azerbaijan it is easier to import goods than spend the money on domestic production infrastructure and other expensive inputs. The group noted that this mentality would be deadly in the long-term as individual economic sectors would atrophy and would not be able to recover quickly.

#### VISITING IMF TEAM BRIEFING

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¶10. (C) In a separate meeting with the diplomatic community on September 6, the IMF's lead staff economist for

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Azerbaijan, Vitali Kramarenko, said that GDP growth for the first six months of 2006 was 35 to 40 percent faster compared to the same period in 2005. The agricultural sector, however, experienced zero percent growth during the first six months of 2006, highlighting the economy's over-reliance on the energy sector. Kramarenko stated that according to official statistics inflation was 10.2 percent to date for the year. In 2005, President Aliyev signed a Presidential Decree that implemented several measures to keep inflation to single-digits, which the GOAJ successfully executed. This decree remains and the GOAJ has yet to abandon the goal of single-digit inflation in 2006.

¶11. (C) According to National Bank data, the money supply has increased 70 percent as the government increased expenditures 70 percent in the first six months of 2006 compared to the same period in 2005. The National Bank continues its policy of currency appreciation and the Azerbaijani manat has already appreciated four percent against the U.S. dollar.

#### 2007 BUDGET

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¶12. (C) Kramarenko indicated that the IMF team had held discussions with the Minister of Finance on the macroeconomic environment and the 2007 state budget preparations. While the final 2007 budget has not been finalized, the Minister of Finance told the IMF that government expenditures will increase 40 percent compared to the 2006 budget. Minister Sharifov said that the GOAJ had originally wanted to increase expenditures by a much larger amount but that he and other economic ministers had cautioned against spending too much

and destabilizing the macroeconomic environment. On the budget revenue side, Kramarenko, stated that the GOAJ is expecting an increase in personal and corporate tax and customs collections. Minister Babayev told Ambassador Derse in July that the GOAJ wanted to increase the collection rate for many public utilities, including water and electricity; Minister of Industry and Energy reiterated recently that goal.

COMMENT

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¶13. (C) The uniform concerns expressed by the international community underscore the need for a sustained, senior-level macroeconomic policy dialogue with the Government of Azerbaijan. The new BP-funded macroeconomic modeling unit at the State Oil Fund (ref a) will help the GOAJ better understand the risks inherent in its current budget planning approach, but it will not provide the strategic guidance and pressure needed to help Azerbaijan successfully balance its competing macroeconomic and development policy needs. Through our new Economic Partnership Commission (ref b), the USG needs to help the GOAJ understand that serious economic reform and revenue management are key to Azerbaijan's stability and in turn its reliability as a partner for the U.S.  
DERSE